2012-2013 BROKER-IN-CHARGE ANNUAL REVIEW

DISCIPLINARY CASES

Outline:
Introduction
Case Fact Situations
Disciplinary Action Results & Comments
Trust Account Mismanagement - An Ongoing Problem
Red Flags & Internal Controls

Learning Objective: After completing this section, brokers-in-charge should have a better understanding of various issues that may arise in brokerage practice and the extent to which licensees, including the broker-in-charge, may bear responsibility for unlawful or inappropriate behavior.

INTRODUCTION

This section describes a number of disciplinary cases the Commission has decided in the recent past. A summary of pertinent facts is presented for each case, followed by questions for discussion regarding the key issues and what provisions of the Real Estate License Law and/or Commission Rules may have been violated. At the end of the section is a description of the Commission's findings and disciplinary action taken, along with explanatory comments where deemed appropriate.

To assist brokers in answering the questions presented in the case fact situations, the relevant portions of the statute specifying conduct that may be subject to disciplinary action are reprinted on the next two pages for reference purposes.

§93A-6. Disciplinary action by Commission.

(a) The Commission has power to take disciplinary action. Upon its own initiative, or on the complaint of any person, the Commission may investigate the actions of any person or entity licensed under this Chapter, or any other person or entity who shall assume to act in such capacity. If the Commission finds probable cause that a licensee has violated any of the provisions of this Chapter, the Commission may hold a hearing on the allegations of misconduct. The Commission has power to *suspend or revoke* at any time a license issued under the provisions of this Chapter, or to *reprimand or censure* any licensee, if, following a hearing, the Commission adjudges the licensee to be guilty of:

(1) Making any willful or negligent misrepresentation or any willful or negligent omission of material fact.

(2) Making any false promises of a character likely to influence, persuade, or induce.

(3) Pursuing a course of misrepresentation or making of false promises through agents, advertising or otherwise.

(4) Acting for more than one party in a transaction without the knowledge of all parties for whom he or she acts.

(5) Accepting a commission or valuable consideration as a real estate broker on provisional status for the performance of any of the acts specified in this Article or Article 4 of this Chapter, from any person except his or her broker-in-charge or licensed broker by whom he or she is employed.

(6) Representing or attempting to represent a real estate broker other than the broker by whom he or she is engaged or associated, without the express knowledge and consent of the broker with whom he or she is associated.

(7) Failing, within a reasonable time, to account for or to remit any monies coming into his or her possession which belong to others.

(8) Being unworthy or incompetent to act as a real estate broker in a manner as to endanger the interest of the public.

(9) Paying a commission or valuable consideration to any person for acts or services performed in violation of this Chapter.

(10) Any other conduct which constitutes improper, fraudulent or dishonest dealing.

(11) Performing or undertaking to perform any legal service, as set forth in G.S. 84-2.1, or any other acts constituting the practice of law.

(12) Commingling the money or other property of his or her principals with his or her own or failure to maintain and deposit in a trust or escrow account in a bank as provided by subsection (g) of this section all money received by him or her as a real estate licensee acting in that capacity, or an escrow agent, or the custodian or manager of the funds of another person or entity which relate to or concern that person's or entity's interest or investment in real property, provided, these accounts shall not bear interest unless the principals authorize in writing the deposit be made in an interest bearing account and also provide for the disbursement of the interest accrued.

(13) Failing to deliver, within a reasonable time, a completed copy of any purchase agreement or offer to buy and sell real estate to the buyer and to the seller.

(14) Failing, at the time a sales transaction is consummated, to deliver to the broker's client a detailed and accurate closing statement showing the receipt and disbursement of all monies relating to the transaction about which the broker knows or reasonably should know. If a closing statement is prepared by an attorney or lawful settlement agent, a broker may rely on the delivery of that statement, but the broker must review the statement for accuracy and notify all parties to the closing of any errors.

(15) Violating any rule adopted by the Commission.

(b) The Commission may suspend or revoke any license issued under the provisions of this Chapter or reprimand or censure any licensee when:

(1) The licensee has obtained a license by false or fraudulent representation;

(2) The licensee has been convicted or has entered a plea of guilty or no contest upon which final judgment is entered by a court of competent jurisdiction in this State, or any other state, of any misdemeanor or felony that involves false swearing, misrepresentation, deceit, extortion, theft, bribery, embezzlement, false pretenses, fraud, forgery, larceny, misappropriation of funds or property, perjury, or any other offense showing professional unfitness or involving moral turpitude which would reasonably affect the licensee's performance in the real estate business;

(3) The licensee has violated any of the provisions of G.S. 93A-6(a) when selling, leasing, or buying the licensee's own property;

(4) The broker's unlicensed employee, who is exempt from the provisions of this Chapter under G.S. 93A-2(c)(6), has committed, in the regular course of business, any act which, if committed by the broker, would constitute a violation of G.S. 93A-6(a) for which the broker could be disciplined; or

(5) The licensee, who is also licensed as an appraiser, attorney, home inspector, mortgage broker, general contractor, or member of another licensed profession or occupation, has been disciplined for an offense under any law involving fraud, theft, misrepresentation, breach of trust or fiduciary responsibility, or willful or negligent malpractice.

CASE FACT SITUATIONS (WITH QUESTIONS FOR DISCUSSION)

Case 1

In October 2009, a small real estate firm listed for sale an unimproved lot in a manufactured home subdivision for $22,000. The lot was the only unimproved lot in the subdivision — all the other lots had manufactured homes located on them, as permitted by the restrictive covenants. The co-owners of the firm, Broker A (who was the broker-in-charge) and Broker B, were co-listing agents for the property. The MLS data sheet stated that the lot could be used for a manufactured or modular home.

In December 2009, the county amended its zoning ordinance effective January 2010 to prohibit any new manufactured homes from being placed in a defined general area that included the manufactured home subdivision where the listed lot was located. This significant zoning change was well publicized in local newspapers; however, the co-listing brokers asserted they were not aware of the zoning change and thus did not correct the MLS information by eliminating the statement that a manufactured home could be placed on the lot.

On October 13, 2010, Buyer signed a buyer agency agreement with the real estate firm and consented to the firm acting as a dual agent in connection with Buyer purchasing the unimproved lot in the subdivision. *The brokers represented to Buyer on more than one occasion that a manufactured home could be placed on the lot as permitted by the restrictive covenants*, but the brokers did not check with the zoning administrator's office to verify that the zoning still permitted placement of a manufactured home on the lot. Buyer made an offer to purchase the lot for $22,000 on the same day and the offer was accepted the next day. *The contract contained a provision stating that there must be no restriction, easement, zoning or other governmental regulation that would prevent the reasonable use of the property for a* ***residential manufactured home.*** Buyer obtained a loan and closed on the purchase on October 22, 2010.

In April 2011, as Buyer began preparations to place a manufactured home on the lot, Buyer learned that the current zoning ordinance prohibited placement of a manufactured home on the lot and complained to the brokers, who claimed to not have previously been aware of the zoning restriction. The real estate firm paid a $200 filing fee for Buyer to request a zoning amendment and assisted Buyer at the hearing on the amendment. The county denied the zoning amendment request.

Buyer subsequently complained to the Commission. The real estate firm and brokers agreed with Buyer to pay Buyer the full amount of the brokerage commission ($1,100) and to list the lot for sale for Buyer at no charge.

Questions for Discussion:

1. Did the brokers have a duty under the License Law to verify the zoning prior to representing to their *buyer* client that placement of a manufactured home on the lot was permitted? Did they have any duty to their *seller* client regarding this issue?

2. Does the fact that all other lots had manufactured homes and that manufactured homes are permitted by the subdivision restrictive covenants have any impact on the brokers' duty in this situation?

3. Under the License Law, does it make any difference that the firm and brokers were dealing with the buyer as a dual agent rather than as a seller's agent? Might this distinction make a difference in a civil lawsuit by the buyer against the brokers and firm?

4. What provisions of the License Law, if any, did the brokers violate and what would be an appropriate disciplinary action in this case? Any mitigating factors?

Note: *Cases 2A and 2B* involve the same broker and firm. Consider and discuss each fact situation separately, however, the Commission findings, disciplinary action and comments for both are combined because the two cases involve similar fact situations and were resolved through one disciplinary consent order.

Case 2A

Broker A was an owner and the broker-in-charge of real estate Firm A. On September 19, 2008, Broker A listed an 11-acre tract for sale through her firm for $39,900. The property had been foreclosed on and was owned by Bank X.

Prospective Buyer was shown the property by his agent, Broker B, on September 23. At 1:38 pm on 9/23, Broker B called Broker A with some questions Prospective Buyer had about the property. At 2:00 pm on 9/23, Broker B's firm called Firm A to determine what contract form should be used for an offer on the property. At 2:51 pm on 9/23, Broker B submitted to Firm A via FAX Prospective Buyer's offer to purchase the property for $43,900, $4,000 more than the listing price. The offer was for cash with no financing contingency.

Also on 9/23, Broker A prepared and submitted to Bank X's asset manager an offer for $35,000 from Great Deal Investments, LLC for the same property, and this offer was accepted by Bank X on 9/24. Broker A did not disclose to Bank X that she and her husband were the sole owners of Great Deal Investments, LLC.

Broker A also neither mentioned nor submitted Prospective Buyer's $43,900 offer to Bank X. The sale closed and Great Deal Investments, LLC subsequently sold the property for $48,500.

Questions for Discussion

1. Did Broker A have a duty to: (a) advise Bank X of Broker A's ownership interest in Great Deal Investments, LLC? (b) advise Bank X of the probable sales price of the property when listing the property? (c) present Prospective Buyer's offer to Bank X?

2. Did Broker A have any duty to Prospective Buyer? If so, what?

3. What provisions of the License Law, if any, did Broker A violate and what would be an appropriate disciplinary action in this case? Any mitigating factors?

Case 2B

Broker A was owner and broker-in-charge of real estate Firm A. Prospective Buyer A, assisted by Broker B, an agent with another company, was shown a condo listed for $250,000 subject to a short sale approval by the condo owner's lender. Prospective Buyer A made an offer of $220,000 on December 22, 2008 that was not accepted, supposedly due to an imminent foreclosure action. On December 29, the property was withdrawn from MLS. Broker B learned that Broker A would likely be the listing agent for the property once it emerged from foreclosure and contacted Broker A in January 2009 expressing Prospective Buyer A's interest in making an offer on the condo as soon as it might be listed by the bank. Prospective Buyer also directly contacted Broker A on two occasions to express her interest in making an offer. Broker A assured both Broker B and Prospective Buyer that she would contact them when the property was listed.

Prospective Buyer B, working with Broker C, who was affiliated with Firm A, had also been shown the same condo in late 2008. On January 13, 2009, Prospective Buyer B, through Broker C, made an offer of $225,000 on the condo (with no owner's name shown on the offer) and the offer was presented to her broker-in-charge, Broker A, who Broker C knew would likely handle the property listing when it emerged from foreclosure.

The condo, now owned by a bank, was listed for sale for $218,900 through Broker A and Firm A on March 27, 2009, but not placed into the MLS until March 30. On March 30, Prospective Buyer B's offer was submitted to the bank by Broker A's assistant and Prospective Buyer B then agreed to a bank counteroffer on March 31 amending the closing date. Prospective Buyer B signed a "purchase addendum" on April 1 and the bank's asset manager actually signed the contract on April 2. It is unclear whether any copy of the contract ever named the bank-owner.

Broker A never advised Prospective Buyer A or her agent, Broker B, of the fact that the condo had again been listed and did not advise the bank that another party was interested in making an offer. Broker A's reason was that she was out of town attending training at the time of the listing and submission of Prospective Buyer B's offer. Broker A also told Broker B and the Commission's investigator that it was Broker B's responsibility to monitor the MLS to see when the condo was listed.

Broker B discovered the new listing on April 2 and Prospective Buyer A submitted an offer to Broker A on April 4, at which time Broker A advised Broker B by email that another offer had been accepted. There was no evidence that the bank was ever made aware of Prospective Buyer A's offer.

Questions for Discussion

1. Is it appropriate to submit an offer with the property owner not named in the offer?

2. If a broker knows that a prospective non-client buyer is very interested in a property that s/he will likely be listing for sale and promises to notify the prospective buyer upon listing the property, does that broker have an obligation to notify the prospective buyer as soon as the property is listed? Why or why not?

3. What provisions of the License Law, if any, did Broker A violate and what would be an appropriate disciplinary action in this case? Any mitigating factors?

Case 3

Between 2005 and 2009, Broker A, broker-in-charge of Firm X, and Broker B of the same firm, listed and sold lots and houses in a subdivision for the developer. The subdivision plat indicated that the subdivision streets were a "public R/W" (right of way), but the streets were actually private streets and the Department of Transportation had not assumed responsibility for maintenance. The developer and the brokers did not make any written disclosures to purchasers regarding the private status of the streets or the fact that property owners were responsible for maintenance. The developer stated to Commission investigators that the streets had, however, been built to DOT standards. Broker B said he believed the situation with the streets was discussed with cooperating brokers representing buyers. One cooperating broker said Broker B told him that the streets would be maintained by DOT. During the course of the Commission's investigation, the developer was able to persuade DOT to assume responsibility for maintaining the subdivision streets.

Questions for Discussion

1. Is the issue of who is responsible for maintenance of subdivision streets a "material fact?"

2. What responsibility, if any, did the developer and the brokers (the developer's agents) have to disclose the status of the subdivision streets to prospective purchasers? Did the fact that the subdivision plat showed the streets as a "public right of way" make any difference?

3. What is the responsibility of a *buyer's* agent to assure that disclosures regarding subdivision streets are properly made to his/her client?

4. What provisions of the License Law or other statutes, if any, did the developer and/or brokers violate, and what would be an appropriate disciplinary action, if any is warranted? Any mitigating factors?

Case 4

Broker A, owner and broker-in-charge of real estate Firm A, claimed that in January 2007, he introduced Buyer A to two developments that were for sale (High Ridge and Black Forest) and that they orally agreed that Broker A would act as a buyer's agent for Buyer A in attempting to purchase the properties and that Buyer would pay Broker A 2% of the purchase price. Buyer A was also a licensed broker and Broker A maintained they had a prior professional relationship and for that reason he did not provide Buyer A with a *Working with Real Estate Agents* disclosure or enter into a written buyer agency agreement with Buyer A. On March 20, 2007, ABC Ventures LLC, acting through its member-manager, Buyer A, submitted offers to purchase both the above-named properties for $20,000,000. The offers were prepared by Buyer A's attorney and submitted directly to the property owners rather than through Broker A. The property owners accepted the offers. The sales contracts specifically provided, however, that the "...*seller* agrees to pay ... commissions of two percent (2%) to Broker A..." [and the same to two other brokers working with the owner]. In April, prior to expiration of the inspection period (i.e., a "free look" period), Buyer A (acting for ABC Ventures), exercised the right to terminate the purchase contracts. Broker A stated that Buyer A told him he thought they could get a better price a little later.

Shortly thereafter, Buyer A commenced negotiations with X for X to buy the High Ridge and Black Forest developments for substantially less than $20,000,000 and then assign the purchase contracts to Buyer A. However, according to Broker A, Buyer A also continued to have discussions with Broker A as though Buyer A still wanted Broker A to be his agent in future dealings regarding the properties. (Buyer A later denied this.) Buyer A subsequently formed Black Ridge Partners, LLC for the purpose of acquiring and holding title to the properties, and on October 3, 2007, purchased the properties through Black Ridge for $14,750,000. This contract did not provide for a brokerage commission to be paid to Broker A. Buyer A subsequently denied ever having a buyer agency relationship with Broker A.

Questions for Discussion

1. When a client is a licensed broker, is it permissible for a broker to skip agency disclosure requirements and to represent the client under an oral agency agreement?

2. Despite Buyer A's denials of an agency relationship with Broker A, does the fact that the March 20, 2007 sales contracts contained a provision stating that Broker A would be paid a 2% commission by the seller not indicate that Broker A had some role in the transaction? Was the $5,250,000 savings Buyer A experienced by canceling the initial contracts and entering into

a subsequent contract for a much lower purchase price possibly a motive to deny having an oral buyer agency agreement with Broker A?

3. What provisions of the License Law and Commission Rules, if any, did Broker A violate and what would be an appropriate disciplinary action in this case?

DISCIPLINARY ACTION RESULTS AND COMMENTS

Case 1

Commission Findings and Disciplinary Action

By **consent order**, the Commission found that the real estate firm and both brokers were guilty of violating G.S. §93-A(6)(a)(1), (3) and (8). The consent orders provided for a *six-month license suspension* for the brokers, but that if the brokers completed an approved continuing education course on the License Law and Commission Rules, the disciplinary action for the brokers and the firm would be converted to a **reprimand**. The brokers each completed a course and received the reprimand. *Possible* mitigating factors might have included: the fact that all other subdivision lots had manufactured homes; the brokers' ready admission of their negligence; the brokers' steps to mitigate the harm to the buyer; and the fact that the buyer had a cause of action against the seller for breach of the contract provision requiring that there be no zoning or other restriction preventing use of the property for a residential manufactured home (although the buyer would obviously incur legal expenses if pursued).

Comments

The brokers had a duty to avoid making any representation regarding a material fact without first verifying the accuracy of the fact represented. First, they should have been aware of the major zoning change because of its extensive publicity and secondly, they should have verified that placement of a manufactured home was still permitted by the zoning ordinance because this issue was critical in this transaction. They misrepresented a material fact, but they did not intentionally misrepresent any facts. Thus, the brokers were guilty of a *negligent misrepresentation* with regard to the *buyer.* The brokers also failed to "discover and disclose" the material fact about the zoning restriction to the *seller,* and thus were also guilty of a *negligent omission* with regard to the *seller*.

Although the fact that all other lots in the subdivision had manufactured homes may make the brokers' conduct more understandable, it did not lessen the brokers' duty to verify that the zoning permitted placement of a manufactured home on the lot because *the right to place a manufactured home on the lot was crucial to the buyer's use of the property and the brokers were well aware that this was the only reason the buyer wanted to purchase the lot.* When a broker working with a buyer knows that a particular property use (e.g., use for a home business, placement of a garage or workshop, etc.) is very important to the buyer and that use may be affected either by restrictive covenants or zoning, the broker has a duty to make reasonable efforts to assist the buyer in assuring that the desired use is permissible and should never make a representation that the use is permissible without confirming that is in fact the case.

The License Law does not distinguish between a seller's agent and a buyer's agent as to the duty to avoid misrepresentation or omission of a material fact. Generally, in *applying* the law, the Commission *may in some instances* find that an agent working with a buyer (as either a seller's subagent or a buyer's agent) is entitled to rely on information about a property provided by the listing agent without making an independent inquiry about the information. (For example, an agent working with a buyer may rely on the accuracy of square footage reported by the listing agent unless a reasonably prudent agent working with a buyer should have clearly recognized that the reported square footage was probably incorrect, or unless the buyer specifically questions the reported square footage.) It is also possible that a court in a civil lawsuit might find a distinction in the level of the duty owed to a buyer as between a seller's agent versus a buyer's agent to *discover* material facts, but no difference in the agent's duty to *disclose* material facts that are or should be known to the broker. In the case at hand, the question is moot, however, since the agents were working as dual agents and their duties were the same to both clients.

Lesson: *Brokers are expected to be knowledgeable about major changes in land use policies and restrictions in their service area and must always be careful to verify the accuracy of any representation they make about permitted or prohibited property uses, whether direct representations to a party or representations made through advertising or promotional information (such as MLS data).* ***Avoid making assumptions about permitted uses of a property based on observed uses of neighboring properties.***

Cases 2A and 2B

Commission Findings and Disciplinary Action

Since Cases 2A and 2B were open cases at the same time and involved similar issues, the Commission disciplined Broker A and Firm A for both cases in one consent order for the broker and a separate order for the firm. The Commission found that the conduct of both Broker A and Firm A (of which Broker A was owner and BIC) in these transactions violated G.S. §93-A(6)(a)(1), (4), (8) and (10).

Broker A. By **consent order,** Broker A's license was *suspended for 18 months*. *Four months of the suspension were active* with the remaining 14 months stayed for a probationary period of one year *provided* that Broker A completed during the four-month active suspension period four (4) approved CE courses on contracts, foreclosure, distressed sales, the License Law or agency in real estate transactions. [Broker A timely completed the education and her license was returned to active status at the end of the four month suspension.]

Firm A. By **consent order,** Firm A's license was suspended for 18 months, but the suspension was stayed upon Broker A's completion of four CE courses.

Comments – Case 2A

The License Law clearly prohibits "acting for more than one party in a transaction without the knowledge of all parties for whom he or she acts." Secretly acting in one's own personal interests (i.e., "self-dealing") in a transaction while also acting as an agent of a party in the same transaction violates this provision. Such conduct also violates the basic agency law duty of loyalty to one's principal and disclosing all information that may influence the principal's decision.

Advising a property owner-client of the estimated probable sales price of the owner's property in connection with listing that property for sale is considered one of the core minimal services a listing broker is expected to perform. Failure to do so constitutes a failure to exercise reasonable care, skill and diligence, one of the basic duties of an agent to his/her principal. Remember, a violation of agency law is considered by the Commission to be a violation of the License Law provisions related to competence and improper conduct.

Similarly, the failure to present a seller-client with a *bona fide* offer from a prospective buyer also clearly violates the basic agency law duty to inform one's principal of all material facts or information that may influence the principal's decision, not to mention the specific License Law prohibition against the willful or negligent omission (i.e., failure to disclose) of a material fact. Moreover, Commission Rule 58A.0106, "Delivery of instruments," requires delivery of offers to the offeree "... immediately but in no event later than five days from the date of execution..."

Thus, Broker A and Firm A clearly violated the duties owed to Bank X under the License Law and agency law in this case. Further, under the Law of Agency an agent owes a **third party** (such as the prospective buyer in this case) the duty of "honesty and fairness." Clearly, the failure of Broker A in this case to present the prospective buyer's offer to the seller violated this duty.

Comments – Case 2B

It is completely inappropriate for a real estate broker to submit an offer with the space for the name of the seller left blank, especially if the seller is an entity rather than an individual. If such an offer was accepted without the name of the seller, its enforceability against the unnamed entity is questionable, unless perhaps the seller is clearly identified elsewhere in the contract. Broker A, the broker-in-charge and listing agent, should not have allowed Prospective Buyer B's offer with an unnamed seller to have been submitted to the bank-owner in that form. If the seller's name is subsequently added, that is a modification of a key provision that the buyer should have acknowledged by his signature or initials and date of change.

A broker is obligated under License Law and agency law to disclose to his/her *client* (principal) any fact relating to a transaction that may influence the principal's decision, material or otherwise. Certainly the prospect of an additional offer on a seller-client's listed property is a material fact and Broker A's failure to inform the bank and also to inform Prospective Buyer A so she could have the opportunity to make an offer constitutes a disservice to Broker A's principal, the bank. Moreover, Broker A's actions create an impression that her actions were intentional so the offer of Prospective Buyer B, who also was a client of Broker A's firm, might have preference over an offer from a buyer produced by a competing broker.

Case 3

Commission Findings and Disciplinary Action

By Consent Order, Brokers A and B were found guilty of violating G.S. §93A-6(a)(1) [misrepresentation or omission of material fact] and (10) [improper conduct]. The licenses of both brokers were suspended for six months, but upon the brokers completing two continuing education courses on specified topics, the suspensions were vacated and the brokers received a **reprimand**.

Comments

*The **developer** has an obligation under state law, G.S. §136-102.6(f), prior to entering into any agreement or any conveyance with a prospective buyer, to provide the buyer a written "subdivision street disclosure statement" that must fully disclose the status (whether public or private) of the street upon which the house or lot fronts.* The developer must have the buyer sign a written acknowledgment of having received the disclosure.

A **broker** has a duty under the License Law to discover and disclose all *material facts* about the property. *Clearly, the matter of who will be responsible for future maintenance of subdivision streets is a material fact*. A broker's duty in this regard is the same under the License Law regardless of whether the broker is acting as a seller's agent or a buyer's agent. Moreover, it is not sufficient for a broker to merely assure that the developer provides the statutorily required disclosure statement. Because the real issue is not whether the streets are "public" or "private," but who is responsible for maintaining the streets, *a broker is expected **at a minimum** to ask the owner who is responsible for maintaining the streets and disclose that information to both prospective buyers and lender. This is especially true where the DOT has **not** assumed responsibility for street maintenance*. Remember that subdivision streets may be dedicated by the developer as "public" streets, but still not have been accepted by the DOT for state maintenance. The DOT must have officially approved the streets for addition to the North Carolina state highway system for maintenance before the streets will be maintained by the state.

Note that one of the brokers in this case allegedly told one cooperating broker representing a buyer that the streets were state-maintained. If true, this would be an affirmative *negligent misrepresentation* (assuming there was no intent to deceive). However, even if no representation was made at all to prospective buyers (or their agents) regarding street maintenance, the failure to discover and disclose that the homeowners were responsible for street maintenance was still a *negligent omission*, thus constituting a violation of G.S. §93A-6(a)(1) in any event. The brokers' conduct also can be considered *improper conduct* under 93A-6(a)(10).

Note also that during the investigation the developer obtained DOT approval of the subdivision's streets as an addition to the state highway system for maintenance. This could have been a mitigating factor, since homeowners will not be harmed financially as they might have been otherwise.

Case 4

Commission Findings and Disciplinary Order

By **consent order**, the Commission found that the conduct of Broker A and Firm A constituted a violation of G.S. §93-A(6)(a)(8), (10) and (15), and Rules 58A.0104(a) and (c) and 58A.0110(a)(7). The consent order for Broker A provided for a 2-year license suspension, with the suspension being stayed after six months if Broker A completed four CE courses on specified topics within the six-month active suspension period. The consent order for Firm A provided for an 18-month license suspension beginning after six months, with the full 18-month suspension being stayed if Broker A completed the CE courses required in his consent order. *Broker A failed to complete the required CE and the full 2-year suspension for Broker A and the full 18-month suspension for Firm A became effective.*

Comments

A broker must comply with the Commission's rule requiring agency agreements to be in writing. Moreover, as noted in the *Update Course* last year and the current year, **new G.S. §93A-13 of the License Law now specifically requires any agreement for brokerage services to be in writing in order for a broker to maintain a legal action against a client/principal for a brokerage fee.**

Lesson: *If you are found by the Commission to have violated the License Law and are able to negotiate a consent order that provides for a more favorable disciplinary action if you take a few CE courses, don't put yourself out of business for longer than necessary by failing to take the CE courses within the prescribed time.*

TRUST ACCOUNT MISMANAGEMENT – AN ONGOING PROBLEM

After refraining from including instruction on Trust Accounts in the BICAR course for several years to avoid criticism from brokers-in-charge taking the course who don't think such instruction is appropriate in the BICAR course, the Commission included a 90-minute segment on "Trust Account Management" in the 2010-11 BICAR course due both to express requests from the Commission and from licensees for training in trust account rules and maintenance and due to the large number of complaints and disciplinary cases involving trust account problems. Despite that fairly recent instruction, *there continues to be an unacceptably large number of instances of noncompliance with trust account rules and good practice guidelines, and much too often such noncompliance results in mismanaged trust accounts and conversion of funds to personal use.*

In order that BICs attending this course might better understand the extent of trust account management problems, presented below is an incomplete list of **32 cases** involving trust account offenses that have resulted in disciplinary action by the Commission in the **nine-month period July 2011 - April 2012 alone**. For more information on these cases, see the October 2011, February 2012 and May 2012 editions of the *Real Estate Bulletin*, which may be viewed on the Commission's website at www.ncrec.gov.

July 2011 - April 2012 Disciplinary Cases Involving Trust Account Violations

1. Qualifying broker/BIC of firm converted trust monies for personal use and failed to maintain proper trust account records.

2. BIC converted $15,000 of a buyer-principal's money that was entrusted to him; broker also created false agency documents and, in another transaction, converted a buyer-principal's $1,000 earnest money deposit for personal use.

3. Broker engaged in sales and property management through an unlicensed firm, failed to maintain trust account records according to Commission rules, and deposited rents and security deposits belonging to others into her personal savings account.

4. BIC's trust account was found in a Commission spot audit to be lacking in many details required by Commission rules.

5. Firm owner/BIC failed to supervise bookkeeper who was to account for deposits and rent payments; $10,000 in cash receipts were not deposited (taken by bookkeeper); BIC failed to review account reconciliations.

6. Firm qualifying broker/BIC failed to maintain trust account according to Commission rules. Trust account held earned commissions, showed "deficit spending," had unrecorded cash withdrawals and a $14,000 shortage as well as generally poor records.

7. Firm BIC permitted a former broker with an expired license to engage in brokerage and maintain the firm's banking and trust accounts. BIC failed to properly supervise the broker in maintaining appropriate records and failed to safeguard trust funds.

8. Firm qualifying broker/BIC engaged in loan fraud by secretly providing earnest money for a buyer of two investment properties and not disclosing this to the buyer's lender. The BIC failed to provide promised tenants for the properties, leading to foreclosure. The BIC's trust account records were also found to be incomplete.

9. Property management firm partner/qualifying broker/BIC failed to deposit $2,300 of tenant security deposits from his old firm's trust account to his new firm's trust account. BIC also misappropriated $1,500 of trust monies for his personal use.

10. Property management firm BIC failed to account for monies received and failed to make trust account records available to the Commission for inspection.

11. Firm BIC converted trust funds by writing checks to himself to pay for office expenses, including $3,195 in checks from the rental account and $3,900 in checks from the security deposit account.

12. Property management firm qualifying broker/BIC failed to remit rents and security deposits to landlord/client; converted client monies for personal use; failed to deposit client monies in a trust account; and failed to make trust account records available to the Commission for inspection.

13. Broker failed to turn over an $8,000 earnest money deposit to his BIC, failed to deposit the earnest money in a trust account, and failed to return the earnest money to the buyer when the purchase failed.

14. Broker acting as property management firm bookkeeper embezzled $500 from firm's rental trust account.

15. Sole proprietor BIC failed to maintain trust account records according to Commission rules and periodically had shortages.

16. Firm BIC deposited $1,000 in earnest money in her operating account rather than her trust account, spent a portion of the money and did not refund the EM as required for one year.

17. Firm BIC failed to keep complete trust account records and failed to reconcile records to bank statements over a 12-year period.

18. Firm BIC failed to maintain trust account records in accordance with Commission rules, failed to deposit all received rents in a trust account and engaged in "deficit spending" from the trust account.

19. Firm owner/BIC failed to maintain trust account records in accordance with Commission rules, including not maintaining a journal or ledgers, not performing monthly reconciliations, not accurately disbursing maintenance fees, and retaining personal funds (earned commissions) in trust account resulting in a $13,000 overage.

20. Firm owner/BIC placed rents, security deposits and other trust monies in an account not designated as a trust account, failed to maintain ledgers, failed to perform monthly reconciliations or trial balances, resulting in both overages and shortages in various client accounts.

21. Firm owner/BIC failed to supervise the individual assigned to manage the firms' trust accounts, resulting in the individual converting trust monies for personal use, and failed to maintain trust account records according to Commission rules.

22. Firm BIC failed to maintain trust account records according to Commission rules and failed to perform monthly reconciliations, resulting in a shortage of $112,000.

23. Firm BIC failed to keep complete trust account records sufficient to establish a clear audit trail and failed to perform monthly reconciliations over a seven-year period.

24. Broker acting as manager of a homeowners' association collected homeowner dues but did not deposit the money into a trust account within three days of receipt, did not report accurately to the homeowners' association in a timely manner and allowed homeowner dues to accumulated for months before making appropriate disposition of the monies.

25. Firm qualifying broker/BIC disbursed rental proceeds to a landlord-client before verifying that the rent checks had cleared, resulting in the proceeds checks to the owner being returned for insufficient funds.

26. Firm qualifying broker/BIC (licensed since 1979) employed a bookkeeper with prior record of bankruptcy and credit card fraud charges without performing background check. BIC failed to supervise the firm bookkeeper (not licensed) and failed to review or perform monthly reconciliations, thus allowing the bookkeeper to embezzle approximately $18,000 in trust money. Bookkeeper bought a car with trust funds and wrote checks to her roommate, among other things. The BIC refused to fire bookkeeper despite requests from her affiliated

licensees to do so. When finally challenged by BIC, bookkeeper took all books, records and old files from office and refused to return them, but BIC kept her employed for another four months hoping to get the records. The records were never returned, reconstruction based on later acquired bank records was inadequate, and BIC had to repay money owed to clients based on whatever amounts the clients claimed they were owed.

27. BIC of brokerage and property management firm managing a homeowners' association charged unauthorized bees to home purchasers, failed to maintain HOA monies in a properly designated trust account, and failed to keep accurate and complete records of trust monies. Also, when acting as a broker for homebuyers and sellers, BIC failed to keep accurate and complete trust account records in accordance with Commission rules.

28. BIC of a property management firm failed to maintain trust account records in accordance with Commission rules, resulting in a shortage of $87,000.

29. Qualifying broker/BIC of a property management firm failed to maintain trust account records in accordance with Commission rules. Among other things, BIC operated the firm's tenant security deposit account on a shortage of $33,580 that had existed for several years and dated to before BIC became BIC of firm.

30. BIC of firm acting as rental agent deducted monies from security deposits of successive tenants for damages for which the tenants were not responsible or which did not exist; charged tenants for repairs which were not made or which did not cost as much as the amount charged to the tenants; and failed to maintain complete records of rental transactions and trust funds. No documents could be provided for deductions from security deposits.

31. Broker operated firm without a firm license, failed to enter into written property management agreements with clients, and failed to maintain rental records and trust accounts for rental proceeds or security deposits, instead depositing these funds into his personal bank account and converting the funds for personal use.

32. Broker engaged in property management business through a firm not registered with the Secretary of State's office or licensed by the Commission and without a designated BIC. Broker maintained incomplete trust account records showing unaccounted for funds in the account and "deficit spending;" and further cashed rental checks and deposited proceeds into a landlord's account instead of depositing the rent into his trust account.

Because of the continuing serious problems with trust account mismanagement, often by licensees who have held a license for many years, the following reminder as to "red flags" and suggested internal controls is included. Major trust account violations are occurring in every part of the state and involve brokers-in-charge who are both experienced and inexperienced. The Commission hopes that brokers-in-charge will take note of the ongoing problems that are occurring, frequently right under the noses of otherwise competent and well-intentioned BICs, and will strive to improve their trust account management practices.

It should also be noted that trust account spot inspections by the Commission's Auditors during the July 2011-June 2012 period showed that of the spot inspections performed, trial balances had not been performed in 44% of the accounts inspected, monthly bank reconciliations were unsatisfactory in 17% of the accounts inspected, and disciplinary hearings resulted from 14% of the inspections.

RED FLAGS & INTERNAL CONTROLS

Red Flags

A ***red flag*** *is a set of circumstances that are unusual in nature or vary from the normal activity*. It is a warning sign that something is out of the ordinary and *should be further investigated*.

Common red flags in real estate trust accounts

(A) Checks can be a source of many different red flags, including:

- NSF notices on checks drawn on the trust account.
- Canceled checks missing from bank statements.
- Excessive voided checks or entries to correct errors (a.k.a. "cooking the books.")
- Checks (and deposits) for large, round figures.
- Checks written to the bookkeeper. (S/he is paid from the operating account!)
- Checks written to an unknown vendor. (Do they really exist?)
- Checks held and not mailed. (Why write the check, but not mail it?)

(B) Likewise, missing trust account records are a red flag. If any of the following are missing, follow-up is a must, both to avoid record-keeping violations and to find out what someone might be trying to hide:

- Cash receipts
- Bank statements, including canceled checks and deposit tickets
- Trust account reconciliations

(C) Similarly, discrepancies between different types of trust account records constitute red flags. Look for:

- Discrepancies between cash receipts and deposit amounts, e.g., cash receipts show $2,250, yet the deposit ticket from the following day is for only $2,000.
- Discrepancies between amounts on bank statements and amounts on trust account records, e.g., journal shows 3 voided checks, yet 2 cleared the bank.

The broker-in-charge must discover the explanation for the discrepancies and document it.

(D) Also, look for vendors with P.O. boxes and no physical address. This may be a red flag that the vendor is not real and is simply a conduit through which a bookkeeper, associate or employee is passing money to him/herself or for his/her benefit.

(E) If you see large transfers of funds between various trust accounts, you may also have a problem. Why is the transfer being made? Does it make sense? Do your files include the proper documentation?

So long as each trust account has check writing privileges, there really is no reason to have transfers between trust accounts. However, if for example, the tenant security deposit account is an interest bearing money market account with no check-writing ability, then when the time comes to disburse the tenant security deposit, the broker must transfer the deposit from the money market account into the general trust checking account and then disburse the funds. Other than that, transfers between trust accounts may indicate a shortage; someone is stealing from the more active account and is trying to subsidize it by borrowing funds from the more stable, unused trust account.

(F) Property owner complaints of late rent proceeds or no rent proceeds or insufficient or low proceeds should be a *huge* red flag for brokers-in-charge. If the rent was received by the broker, then why is it that the owner hasn't received the net rent proceeds two months later? It's amazing how patient some owners are, waiting 4-6 months before contacting the Real Estate Commission. Such complaints garner the attention of the Commission's auditors *quickly*.

(G) Finally, employees themselves can be red flags. Look for:

- Employee lifestyle changes. (New car/jewelry/trips - a.k.a. "why is your bookkeeper living better than you?")
- Bookkeeper/employee who is obsessed with the mail. (Seeks to intercept and "screen" the mail to remove NSF notices, owner complaints, etc.)
- Bookkeeper/employee who never takes time off. (Why not?)

A broker-in-charge may authorize a secretary, bookkeeper or other employee to collect trust money, make deposits, sign trust account checks, make bookkeeping entries and reconcile trust account bank statements to the journal and ledgers. However, it is the responsibility of the broker-in-charge to make sure the trust account and related records are properly maintained. If an employee misappropriates trust funds, the broker-in-charge may well be held responsible.

In many cases, after it is discovered that an employee has misappropriated trust funds, it becomes clear that red flags were present. Had the broker-in-charge recognized these red flags, the loss might not have occurred or at least would have been substantially reduced. ***A broker-in-charge should be able to discover most trust account abuses quickly (no later than a month or two) if he or she reviews the records regularly and watches for the red flags described above***. If a broker-in-charge realizes in relatively short order that there may be a problem with the trust account and investigates it and documents what happened and makes it right, then chances are s/he may not be disciplined. The longer the embezzlement persists and the larger the sum of misappropriated funds grows, the more likely the broker-in-charge may lose his/her license for some period, because s/he was not fulfilling his/her supervisory duties to monitor the trust account.

Internal Controls

Internal controls *are policies and procedures designed to safeguard the assets of a business and ensure the accuracy of its financial records*.

Recommended Internal Controls

- Separate the handling of cash from bookkeeping. This helps avoid a situation where a bookkeeper is hiding cash receipts. If someone else knows monies were received and makes a record of receipt, the bookkeeper is less able to take the cash.

- Each employee handling cash should have his or her own cash drawer and account for cash daily.

- Use sequentially numbered cash receipts and compare cash receipts to deposit tickets daily.

- Employees handling cash should be bonded. A bond is like insurance. If an employee does take money improperly, the bond provides coverage. Understand that E&O coverage will not pay one cent for trust account misappropriation as that is an intentional act. Thus, absent bonding, the owners of the company and/or the broker-in-charge may be obligated to personally restore all missing trust funds if the company wants to continue in business.

- Any mail bearing the bank's return address is delivered to the broker-in-charge's desk unopened and is opened first by the broker-in-charge. Compare this month's balance to last, and to prior months' balances. Is the balance significantly lower or steadily declining? Should it be? Have "voided" checks cleared the bank?

- Review checks for unusual amounts or unknown payees. Consider requiring at least two signatures on every trust account check with only two or three people having authority to sign.

- Examine monthly reconciliations and the entire trial balance for accuracy, even if it is pages long.

- Maintain an approved vendor list. The bookkeeper may write checks to anyone on the list, but if a vendor is used who is not on the list, then only the broker-in-charge may sign that check.

- Adequately screen job applicants who will have access to cash, e.g., criminal record check, contact previous employers, etc.

- Actively supervise the bookkeeper and others handling cash.

- Have the books audited periodically by a C. P. A., particularly one experienced in detecting fraud, rather than one who primarily prepares tax returns, or occasionally hire a certified fraud examiner (CFE) to review your records.

In evaluating internal controls, focus on the areas in your practice that are most susceptible to fraud and abuse. Identify what procedures should be in place and then actively supervise the employees to make sure those procedures are being followed on a regular basis.